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Reform of Income Taxes as a Part of Public Budgets Stabilisation

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Reform of Income Taxes as a Part of Public Budgets Stabilisation

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Key words

Tax reform, income taxes, state budget, income tax of legal entities, income tax of private individuals, employee taxation

Introduction

Each tax reform is a substantial, system change of the entire taxation system. Commonly, it is a reaction to a substantial change in economic, social and/or political conditions, and its purpose is to adjust the taxation system to such changes, secure economic growth and a greater tax fairness.

Since January 2008, dramatic changes in taxation laws have taken place resulting particularly from Act on Public Budgets Stabilisation, No. 261/2007 Coll. The income tax act has observed the greatest changes, but all other taxation laws have been affected as well. As quite a novelty, environmental taxes have been introduced, namely:

- natural gas tax and tax on some other gases,
- fossil fuels tax,
- electricity tax.

Under the stipulated conditions, these taxes shall be returned by business entities.

Income taxes still belong among the pillars of each modern taxation system. The fact that their proportion in tax incomes has been falling in the recent years and an increase in indirect taxes is recommended shall not affect this situation. In spite of that, income taxes are viewed very sensitively and within the frame of a reform of public finances dramatic changes both in their overall construction as well as in every year's partial amendments are carried out.

First and foremost, income taxes should be viewed positively¹. They should be viewed as:

- fair,
- bearable,
- simple and
- legally perfectly viewed.

They should fulfil stimulation role and in addition to that they should provide sufficient barrier against tax evasion, of international scope as well, but concurrently, double taxation should be avoided.

1. Tax income

At the end-2007, the total income achieved the amount of CZK 1025.9bn, providing that tax income accounted for 52.0 % of the total income (in 2006, 50.8 %), insurance

¹ Kubátová, K., Vybíhal, V. a kol. Optimalizace daňového systému ČR. Eurolex Bohemia, Praha 2004. ISBN 80-86861-05-8

premium and social security income accounted for 35.8 % of the total income (in 2006, 36.2 %) and non-tax and other income accounted for 12.2 % of the total income (in 2006, 13.0 %).

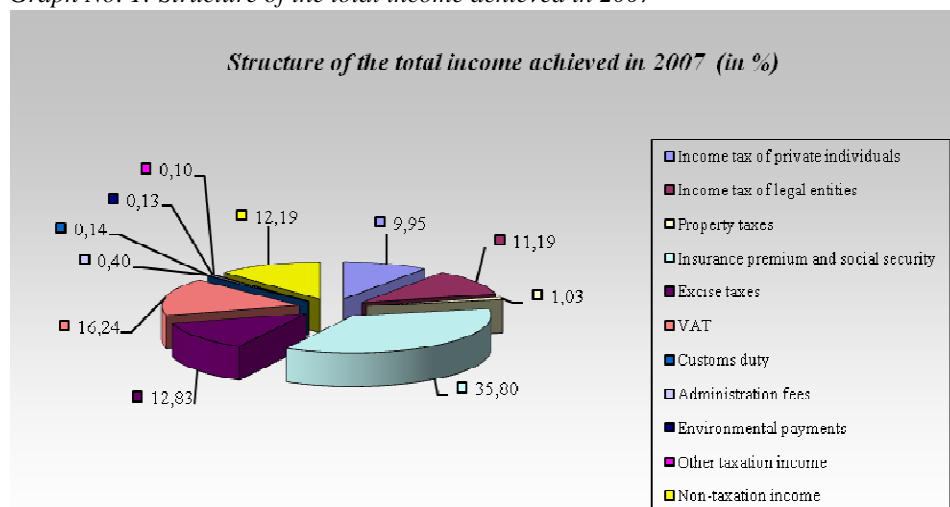
The graph below indicates a distribution of the state budget income and it shows the data with respect to the total income achieved in 2007.

Table No. 1: State Budgeted income distribution in 2007

Income structure	Proportion in the total income in %
Income tax of private individuals	9,95
Income tax of legal entities	11,19
Property taxes	1,03
Insurance premium and social security	35,80
Excise taxes	12,83
VAT	16,24
Customs duty	0,14
Administration fees	0,40
Environmental payments	0,13
Other taxation income	0,10
Non-taxation income	12,19

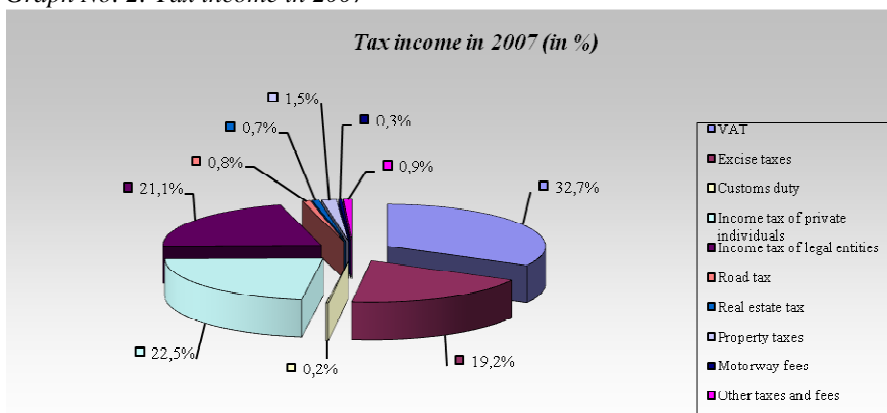
Source: Preliminary results of the fulfilment of the State Budget of the Czech Republic in 2007. www.mfcr.cz

Graph No. 1: Structure of the total income achieved in 2007



Source: Preliminary results of the fulfilment of the State Budget of the Czech Republic in 2007. www.mfcr.cz

Graph No. 2: Tax income in 2007



Source: Preliminary results of the fulfilment of the State Budget of the Czech Republic in 2007. www.mfcr.cz

For illustration, the following table shows the public budget tax income in the period of 2005 – 2007 classified by the individual sorts of tax. The table and graph below shows that the value added tax has the greatest benefits.

Table No. 2: Public budget incomes in the period of 2005 - 2007

Tax income	2005 ² (in CZK bn)	2006 ³ (in CZK bn)	2007 ⁴ (in CZK bn)
VAT	208,41	217,78	236,38
Excise tax	110,52	119,55	138,95
Customs duty	1,25	1,22	1,44
Income tax of legal entities	142,25	135,44	162,79
Income tax of private individuals	143,67	136,92	151,97
- from capital revenue	6,42	7,43	8,58
- employment-related	110,67	111,63	126,39
- reported in returns	26,58	17,85	17
Road tax	5,19	5,43	5,92
Real estate tax	4,99	5,02	5,12
Property taxes	8,11	8,52	10,58
Motorway toll	2,55	3,1	2,4
Other taxes and charges	4,32	5,01	6,38

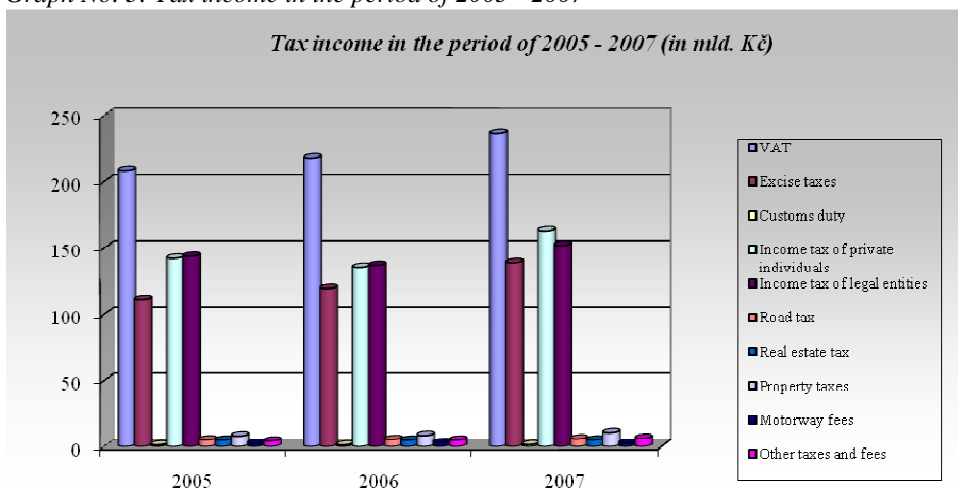
Source: Preliminary results of the fulfilment of the State Budget of the Czech Republic in 2007. www.mfcr.cz

² In the budget of the national taxes in 2005 the legal entities' income tax for municipalities in the amount of CZK 5.8bn is not included; neither are included administration and local fees in the amount of CZK 5.1bn and other taxes in the amount of CZK 4.2bn (in reality, they can be seen only in the accounting books).

³ In the budget of the national taxes in 2006 the legal entities' income tax for municipalities in the amount of CZK 6.1bn is not included; neither are included administration and local fees in the amount of CZK 5.9bn and pollution fees in the amount of CZK 5.1bn (in reality, they can be seen only in the accounting books).

⁴ In the budget of the national taxes in 2007 the legal entities' income tax for municipalities in the amount of CZK 6.2bn is not included; neither are included administration and local fees in the amount of CZK 6.2bn and pollution fees in the amount of CZK 4.9bn (in reality, they can be seen only in the accounting books).

Graph No. 3: Tax income in the period of 2005 - 2007



Source: Preliminary results of the fulfilment of the State Budget of the Czech Republic in 2007. www.mfcr.cz

2. Income tax of legal entities

Income tax of legal entities, sometimes coined as corporation tax, is quite a new tax in modern taxation systems. In the recent years, disputes are held at the theoretical level regarding whether their existence is appropriate or/and necessary at all. A tendency can be traced of the development of taxation systems of the individual countries related to a gradual transfer from a direct to indirect taxation. In compliance with the overall tendency to reduce taxation of income and gradual transfer of the tax liability in favour of taxation of consumption, this trend can be observed in our country as well. This fact is demonstrated in the table and graph below, where the development of taxation of companies' income from its reestablishment within the tax reform until 2010 is shown.⁵

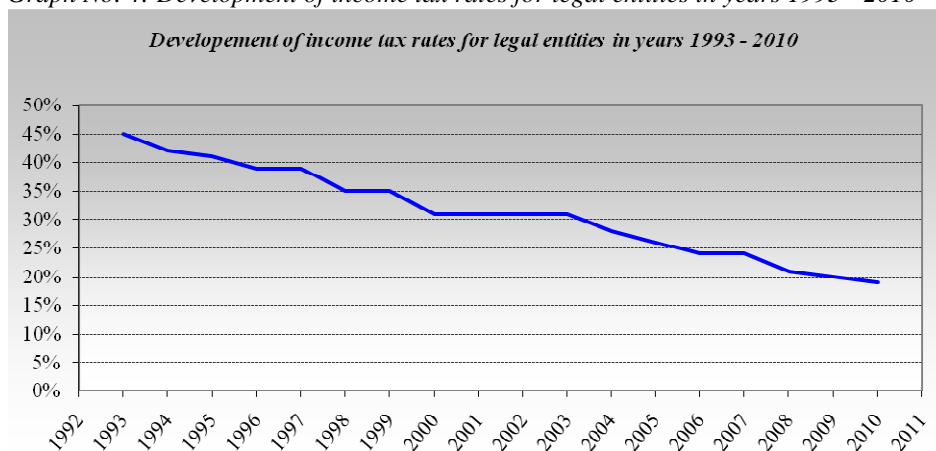
Table No. 3: Development of income tax rates for legal entities in years 1993-2010

Year	Percentage rate	Year	Percentage rate
1993	45 %	2004	28 %
1994	42 %	2005	26 %
1995	41 %	2006-07	24 %
1996- 97	39 %	2008	21 %
1998-99	35 %	2009	20 %
2000 -03	31 %	2010	19 %

At the present time, this tax accounts for slightly over 11 % of the total tax income. However, the income tax of legal entities is still an important component of tax income of the Czech Republic. It is a universal income tax and all and any legal entities are subject to it.

⁵ Pursuant to the Public Budgets Stabilization Act, a gradual reduction in the income tax rate of legal entities – from 1 January 2008, from the current 24 % to 21 %, and then to 20 %, with the effect from 1 January 2009, or, where appropriate, to 19 %, with the effect from 1 January 2010.

Graph No. 4: Development of income tax rates for legal entities in years 1993 - 2010



3. Income tax of private individuals

Income tax of private individuals is a tax which is mostly viewed and discussed. It is the most noticeable for each of us and political representations associate with it the largest expectations. Therefore, any changes in its construction are perceived and it may be assumed that they can have vast impacts on individuals' economic decision-making, their willingness to work, carry on business, but also on the structure of their need and, last but not least, on their political preferences.

Private individuals' tax income can be as a matter of fact divided into two large groups, namely:

- income from activity,
- income from assets (investments).

Income from activity represents the greatest contribution in terms of private individuals' income tax. Income from assets is only a complement in terms of the subject of private individuals' tax. Last but not least, private individuals' participation in health insurance and social security and state employment policy (hereinafter only social security) should be mentioned, which dramatically increases tax burden and concurrently makes workforce more expensive (in the form of mandatory tax payments for employees). The construction of a personal income tax is relatively very complicated and high requirements are associated with it. Every taxable income from activity of a private individual is divided into several relatively independently assessed components:

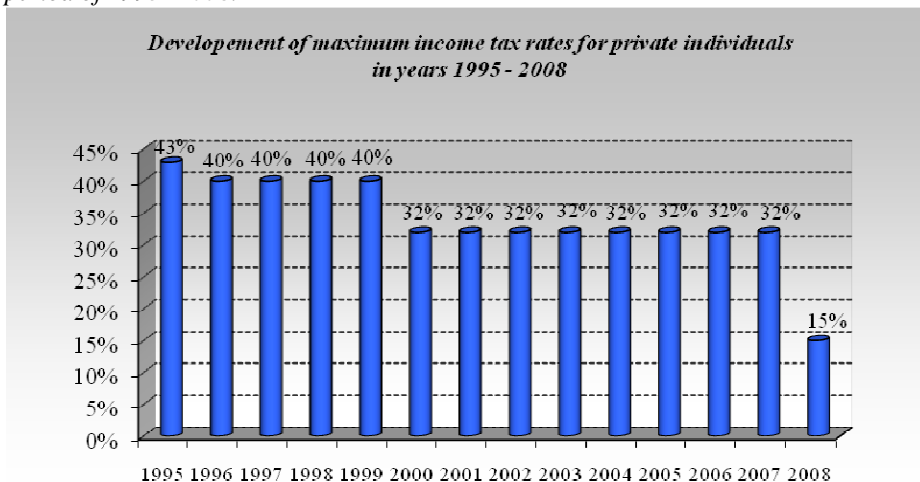
- income from employment-related activities and emoluments,
- income from business activity and any other independent paid activity,
- income from capital assets,
- income from rents,
- other income.

Substantial changes can be observed in taxation of private individuals' income since 2008. The sliding progressive scale of the tax rate with the current rates from 12 % to

32 % is abandoned, and a *unified rate* of private individuals' income tax in the amount of 15 % is introduced. Thus change, which however is not so called "flat tax", for which it could be by mistaken taken when simplifying the viewpoint, then unavoidably called for another intervention with the non-tax components, tax remissions, substantial changes in determination of the tax base and other measures, in particular in the interest of that that in terms of income tax of private individuals no further increase of tax burden in any of the income groups of taxpayers would occur.

The graph below shows the development of the maximum taxation rate of private individuals' income in the period from 1995 until now.

Graph No. 5: Development of the maximum income tax rate for private individuals in the period of 1995- 2008.



However, the unified tax rate in the amount of 15 % in 2008 should lead to:

- limitation of tendency to tax evasion,
- positive effects, especially for companies which employ qualified and highly paid staff,
- support of willingness to carry on business.

Along with the growth of the average wage in the Czech Republic, the limit for minimal tax base increased as well. Where the taxpayer carried on business during the entire period of 2007 and he did not fall under any exception, to which the minimum tax base applied, his entire tax base must amount to no less than CZK 120,800, even in the case that it is actually lower or even if he has made a loss. Since 2008, the provision regarding the minimum tax base has been abolished. The reasons are as follows:

- simplification of the business environment,
- reduction in the tax burden of small entrepreneurs,
- support of sectors and regions with below-standard profit rate.

3.1 Taxation of employees

The major burden of tax load in the Czech Republic is borne by employees. The Czech Republic has approximately ten million inhabitants, in which approx. five million inhabitants takes part in payment of income tax of private individuals, in which there are four million employees who pay tax.

The introduction of the **unified rate** of 15 % is the key change, from which some other less significant changes of the Act are derived. This is also connected to extension of the tax rate⁶ of private individuals and an introduction of so-called "**super-gross wage**". Since 2008, unlike it has been so far, the employees' income shall not be reduced for the purposes of calculation of the tax base from employment-related activity by insurance premium, which is deducted by the employer but the employee is liable to pay (a total of 12.5 % of the gross wage). Besides that, in accordance with the current applicable regulations in the area of social and health insurance, the employer shall be bound to pay insurance premium in the amount of 35 % of his employees' gross wage, and it is exactly this insurance premium which shall increase the employee's tax base for the purposes of the act on income tax. In simple terms, this means that the income from employment increased by 35 % shall be the employee's tax base. However, this increase of 35 % shall not increase the basis of assessment for obligatory insurance premium for the employee's social and health insurance, since it is exclusively a matter regarding the act on income tax. The following table shows a calculation of wage in 2007 and 2008⁷.

Table No. 4: A calculation of net wage and mandatory tax payments

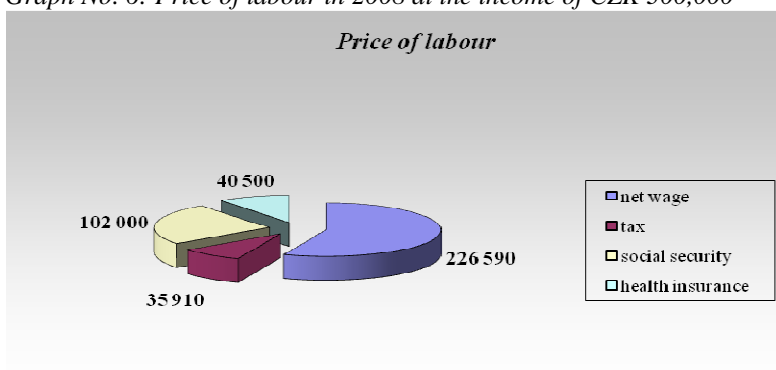
Description	2007	2008	Diff.
Gross wage (GW) – monthly income of 25,000	300 000	300 000	
Employee's social security (8 % of GW)	24 000	24 000	
Employee's health insurance (4.5 % of GW)	13 500	13 500	
Employee's social security paid by the employer (26 % of GW)	78 000	78 000	
Employee's health insurance paid by the employer (9 % of GW)	27 000	27 000	
Tax base (rounded down to CZK 100's)	262 500	405 000	142 400
Tax	44 037	60 750	
Taxpayer's abatement	7 200	24 840	17 640
Tax after abatement	36 837	35 910	927
Net wage	225 663	226 590	927

On the one hand, employees' tax base shall dramatically increase, on the other hand, there will be considerable tax abatements, which, along with the single tax rate of 15% should, in principle, secure that taxation shall not increase and, on the contrary, many would pay lower income tax than to date.

⁶ includes also social and health insurance paid by the employer

⁷ In calculation, it is assumed that the taxpayer applies a tax abatement per taxpayer pursuant to Section 35 of Income Taxes Act, No. 586/92 Coll., as amended.

Graph No. 6: Price of labour in 2008 at the income of CZK 300,000⁸



The employer shall have to return for this employee another 35 %, i.e. CZK 105,000. Accordingly, the total tax payments in 2008 amount to CZK 178,410. (24 000 + 13 500 + 35 910 + 105 000).

In particular employees with children shall take advantage of the super-gross wage. They should, when receiving low or on the contrary high wages, save several hundreds of Czech crowns with respect to income tax. Taking into consideration tax reliefs for children, hence comparing childless employees before the reform and after the reform – the taxpayers who taxed their income at least in the 25% taxation bracket shall take advantage of the super-gross wage. The table below shows impacts of changes in income tax of private individuals with respect to selected types of employees' households in 2008 (in CZK per month):

Table No. 5: Impacts of changes of income tax of private individuals for selected types of employees' households in 2008 (in CZK per month)

Tax impact (difference 2008-2007)	Monthly gross wage								
	10 000	15 000	20 000	25 000	30 000	40 000	50 000	75 000	100 000
Employee, childless	-450	-219	-38	-77	-159	-839	-1614	-3552	-6539
Employee, 1 child	-840	-609	-428	-467	-549	-1229	-2004	-3942	-6929
Household, 1 child, joint taxation	-390	-577	-940	-658	-479	-116	-195	-1328	-4318
Household, 2 children, joint taxation	-780	-967	-1330	-1048	-869	-509	-585	-1718	-4708
Household, 3 children, joint taxation	-1170	-1357	-1720	-1438	-1259	-896	-975	-2108	-5098

Source: Tax reform of public finances in 2007. www.mfcr.cz

The super-gross wage does not include everything. This principle is not applied to insurance premium. For instance, compensation shall be excluded from the basis of

⁸ monthly gross wage of CZK 25,000

assessment also in 2008. Neither shall it be applied to bonuses, from which the employer, due to the achievement of the minimum basis of assessment, does not return insurance premium. Persons working subject to agreement on job performance are not considered to be employees under the regulations on insurance premium; therefore, the super-gross wage shall not be applied to them.

Since 2006, *tax abatements* have replaced all common types of deduction from the tax base. This shall not be changed in any respect even in 2008; the amount of the individual tax abatements is new. Of course, the tax preference related to children shall continue to be applied. The application of tax abatements is related to meeting the conditions stipulated by law and demonstration of the specified facts in a prescribed manner. The tables below show tax abatements applicable for 2007 and 2008:

Table No. 6: Annual tax abatements

Abatement type	2007	2008
For a taxpayer	CZK 7,200	CZK 24,840
For a taxpayer – pensioner	CZK 0	CZK 24,840
Tax abatements for a sustained person:		
Wife (husband)	CZK 4,200	CZK 24,840
Wife (husband) – handicapped	CZK 8,400	CZK 49,680
For a disability beneficiary		
- partial	CZK 1,500	CZK 2,520
- full	CZK 3,000	CZK 5,040
For a handicapped person card holder	CZK 9,600	CZK 16,140
For a student	CZK 2,400	CZK 4,020

Table No. 7: Monthly tax abatements

Abatement type	2007	2008
For a taxpayer	CZK 600	CZK 2,070
For a taxpayer – pensioner	CZK 0	CZK 2,070
Tax abatements for a sustained person:		
Wife (husband)	Only annually	Only annually
Wife (husband) – handicapped	Only annually	Only annually
For a disability beneficiary		
- partial	CZK 125	CZK 210
- full	CZK 250	CZK 420
For a handicapped person card holder	CZK 800	CZK 1,345
For a student	CZK 200	CZK 335

The great advantage of the new regulation rests in that that also taxpayers receiving retirement pension may use the tax abatement per a taxpayer in the amount of CZK 24,840. So far, a retired pensioner carrying on business or employed retired pensioner was not entitled to receive the tax abatement per taxpayer, if his/her pension amounted to more than CZK 38,040 per year, which is the vast majority of retired pensioners. Applying a tax abatement means that pensions up to the amount of CZK 364 thousand per year shall not be taxed. Therefore, a total of several thousand pension beneficiaries shall be allowed to use the tax advantage.

Table No. 8: Tax preference for children

Tax preference for children	2007	2008
Annual tax preference:		
- for a child	CZK 6,000	CZK 10,680
- for a child – handicapped	CZK 12,000	CZK 21,360
Maximum annual tax bonus	CZK 30,000	CZK 52,200
Monthly tax preference:		
- for a child	CZK 500	CZK 890
- for a child – ZTP/P	CZK 1,000	CZK 1,780
Maximum monthly tax bonus	CZK 2,500	CZK 4,350

Recently, the taxpayer may apply the tax bonus for children⁹ up to the amount of CZK 52,200 per year, instead of the current CZK 30,000. This is connected to the introduced tax preference for a child.

Introducing a unified rate of tax enabled to abolish those provisions which as a matter of fact were redundant due to the absence of tax progression depending on the amount of the tax base. They include:

- abolishing the institute of taxation of married couples,
- abolishing the possibility to calculate tax on income achieved in multiple taxation periods,
- abolishing the independent tax base.

Since 2008, *joint taxation of married couples* has been abolished, which means that in the year 2008 married couples may not apply the joint taxation of married couples¹⁰. The advantages of this procedure of income taxation were beyond dispute and families with children nationwide received CZK 5bn lower tax burden. In spite of abolishing the joint taxation of married couples, this advantage shall be basically maintained, both due to the change in the tax rate and, in particular, due to a radical increase of tax abatements per taxpayer, the second of the married couple and tax preference with respect to a child. However, there is one group of marriages with children who will be disadvantaged compared to the current state. They concern those marriages where one of the parents receives disability pension and does not have taxable income. As a rule, this pension is greater than CZK 38,040. Therefore, the Ministry of Finance is considering to remedy this state by a proposal of the law amendment, probably by means of a more dramatic increase in the limit of one's income so that the vast majority of married couples could apply a tax abatement in the amount of CZK 24,840 even with respect to a husband without taxable income.

Summary

Commencing in 2008, income taxation is undergoing substantial changes, which are unprecedented in terms of their scope and contents since 1993. These changes are stipulated in the first part, Art. 1 of the Act on Public Budgets' Stabilisation, No. 261/2007 Coll. This Act introduces a unified rate of income tax of private individuals,

⁹ i.e. where the taxpayer's entitlement to tax abatement for a child is greater than the tax liability calculated for the respective taxation period, the arisen difference is a tax bonus, or, it is a form of a negative tax

¹⁰ still applicable in 2007

unlike the hitherto sliding progressive scale of the tax rate. In connection to this, in the interest of a possible disadvantaging of any of the taxpayer groups, a dramatic increase in tax abatements having a relation to the taxpayer is laid down and on the contrary it stipulates substantially different method of determination of tax base, especially in connection to payment of statutory insurance premium. In addition, it abolishes some tax institutes, such as joint taxation of married couples and a minimum tax base.

Resumé

V návaznosti na změny daňových předpisů v okolních zemích a v neposlední řadě v souvislosti s reformou veřejných financí se opět do popředí dostává otázka dalšího vývoje českého daňového systému. Prvotním důvodem existence daní je jejich funkce fiskální tj. zajistit dostatečné zdroje veřejných rozpočtů pro financování veřejných statků, ale daňová politika musí být prováděna souběžně s opatřeními na výdajové straně veřejných rozpočtů, tzn., je třeba vnímat daňovou politiku v kontextu celkové finanční a hospodářské politiky státu.

Daně jsou však ze své podstaty průřezovým nástrojem, který ve větší či menší míře zasahuje do sociální, hospodářské, enviromentální, zahraniční a dalších politik vlády. Mnohé změny v úpravě daní jsou proto výsledkem vládních priorit v jiné oblasti.

Ve zdaňování příjmů dochází počínaje rokem 2008 ke zcela zásadním změnám, které co do rozsahu a svého obsahu nemají obdoby od roku 1993. Tyto změny jsou obsaženy v části první, čl. 1 zákona č. 261/2007 Sb., o stabilizaci veřejných rozpočtů. Tento zákon totiž zavádí jednotnou sazbu daně z příjmů fyzických osob na rozdíl od dosavadní klouzavě progresivní stupnice daňové sazby. V návaznosti na to pak v zájmu pokud možného neznevýhodnění žádné ze skupin poplatníků stanovuje výrazné zvýšení slev na dani majících vazbu na osobu poplatníka a naopak stanoví zásadně odlišný způsob stanovení základu daně, a to zejména v souvislosti s placením zákonného pojistného. Současně ruší některé daňové instituty, jako je např. společné zdanění manželů a minimální základ daně.

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JEL klasifikace: K34 - Tax Law

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